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TO RUEHC/SECSTATE WASHDC 7166
RUEATRS/DEPT OF TREASURY WASHDC
INFO RUEHZS/ASSOCIATION OF SOUTHEAST ASIAN NATIONS
RUCPDOC/DEPT OF COMMERCE WASHDC
RUEHKO/AMEMBASSY TOKYO 1172
RUEHBJ/AMEMBASSY BEIJING 4517
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UNCLAS SECTION 01 OF 03 JAKARTA 003247

SIPDIS

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DEPT FOR EAP/MTS AND EB/IFD/OMA
TREASURY FOR IA-SETH SEARLS AND JWEEKS
SINGAPORE FOR SBAKER
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DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR TCURRAN
DEPARTMENT PASS EXIM BANK

E.O. 12598: N/A

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SUBJECT: INDONESIAN ECONOMIC GROWTH ACCELERATES, BENEFITS SLOW TO TRICKLE DOWN

¶11. (SBU) Summary. Indonesia's GDP expanded a stronger than expected 6.5% year-on-year (y-o-y) during the third quarter of 2007 on robust domestic demand and a higher investment rate. Growth in the agriculture and service sectors outperformed the expansion of manufacturing activity. Despite more rapid economic growth, there is little evidence that the standard of living of the majority of Indonesians is improving at a meaningful rate. The outlook for job growth remains weak and the incidence of poverty high. If the current government's economic policy mix cannot generate jobs, reduce poverty and improve the standard of living for average Indonesians, pressure for policy changes with a more immediate impact are likely to mount. End Summary.

Domestic Consumption Fuels Stronger Growth

¶12. (U) Indonesia's GDP expanded at a faster than expected pace during the third quarter of 2007, jumping 6.5% (y-o-y). Strong domestic demand and a higher investment rate supported the rapid growth. Government consumption also rose more quickly than in previous quarters, increasing 6.5% (y-o-y), in response to Government of Indonesia's (GOI) effort to expand spending during the second half of 2007. Up to October, however, 2007 budget realization still shows Rp 17 trillion (\$1.8 billion) surplus, due to slow implementation of both central and local government spending. Export growth continued albeit at a slower pace than the first half of the year and considerably slower than rates in early 2006. Exports of goods and service expanded 7.8% (y-o-y) during the quarter, while imports rose 8.1 % over the same period. Strong investment, consumption, and import growth (a large portion of which is intermediate goods) indicate continued strong growth momentum through the end of the year.

Table 1: Real GDP Growth, 2006-2007, Year-on-Year

	2006	2007	2007	2007
	Q4	Q1	Q2	Q3
Private Consumption	3.8	4.5	4.7	5.3

Government Consumption	2.2	4.3	3.8	6.5
Fixed Capital Formation	8.2	7.5	6.9	8.8
Exports of Goods and Services	6.1	8.9	9.8	7.8
Imports of Goods and Services	9.7	8.4	7.2	8.1
GDP	6.1	6.0	6.3	6.5

Source: Central Bureau of Statistics

Agriculture, Services Expand Rapidly

¶13. (U) On the production side, the agriculture sector expanded 8.9%, following less than 1.0% (y-o-y) growth in the sector during the first half of the year. Analysts attribute the pick up in agricultural activity to rapid growth in palm oil plantations. Growth in services continued to dominate other sectors, with growth in the trade/hotel/restaurant, transportation/communications, and financial services sectors comprising over 40 percent of total GDP expansion. Manufacturing growth continued to lag most other sectors, with manufacturing activity expanding just 4.5% (y-o-y) during the quarter.

¶14. (U) Bank lending continued to expand, rising over 22% year-to-date according to Bank Indonesia (BI) officials. However, a large share of the growth in lending is concentrated in the capital-intensive natural resource sector. According to Bank Indonesia data, credit growth to the mining sector rose 75% during the January-to-June period. In contrast, lending to labor-intensive

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manufacturing firms was much slower, increasing only 11% over the same period. The spread between lending and deposit rates is still high.

Table 2: 2007 3Q GDP Growth by Industry (percent)

	Growth Rate	Share GDP Grow.
Agriculture/Livestock/Forestry and Fishery	8.9	20.0
Mining and Quarrying	1.8	3.1
Manufacturing	4.5	18.5
Electricity/Gas/Water	11.7	1.5
Construction	7.5	7.7
Trade/Hotel/Restaurant	6.9	18.5
Transport/Communication	12.5	12.3
Financial/Bus. Service	8.0	10.8
Services	5.7	7.7
GDP	6.5	100.0

Note: Share of GDP Growth (Share GDP Grow.)

Source: Central Bureau of Statistics

Average Standard of Living Slow to Improve

¶14. (U) Despite more rapid economic growth, there is little evidence that the standard of living of the majority of Indonesians is improving at a meaningful rate. While unemployment has trended downward this year, the rate of decline lags the rate of economic expansion. According to the Coordinating Ministry for Economic Affairs, the open unemployment rate dropped slightly from 11.1% in February 2006 to 10.6% in February 2007. However, the rate of unemployment has failed to return to its 2003 level of 9.6%, and remains among the highest in the region. (Note Unemployment statistics in Indonesia do not accurately reflect a large informal sector.)

¶15. (U) The outlook for job growth is also weak. Similar to bank lending, much of the large-scale foreign direct investment (FDI) initially generated few new jobs. For example, BP is investing \$6.8 billion in a liquefied natural gas plant in Papua, but the plant will generate only 400-500 long-term jobs. In contrast, a recent \$1 billion Intel investment in Vietnam will generate roughly 4,000 jobs. Intel has also invested \$3.3 billion in Malaysia and \$1.5 billion in the Philippines, creating 10,600 jobs and 1,000 jobs, respectively. Increasingly intense regional competition for FDI means Indonesia must improve its investment climate in both absolute and relative terms to attract new jobs.

Poverty Remains High

¶16. (U) The incidence of poverty in Indonesia also remains high. The portion of the population living under the official poverty line (\$1.55 a day) dropped to 16.6% from 17.8% from March 2006 to March 2007, reversing the poverty rate rise that occurred during previous 12 months. Nevertheless, World Bank estimates indicate that over 45% of the population still lives on less than \$2 a day, meaning a huge portion of the population remains extremely vulnerable. In line with this trend, income inequality in Indonesia has worsened over the past ten years, suggesting wealthy Indonesians are gaining the most from more robust economic growth and macroeconomic stability. The World Bank's estimate of Indonesia's Gini Coefficient moved from 31.0 to 37.6 over the period 1999 to 2007. (Note: The Gini Coefficient ranges from zero, where all households have the same income, to 100, where one individual earns all the income of the country). Moreover, the World Bank recently reported that nominal wage increases in Indonesia have failed to keep pace with inflation for the past two years.

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¶17. (SBU) Because so many Indonesians live at or near the poverty line, the high prices of staple products, such as rice and cooking oil, have a significant negative impact on household incomes. Although the price of rice has stabilized in recent months, it remains historically high due to poor harvests and government restrictions on rice imports. The lack of investment in irrigation equipment in recent years keeps farmers in many areas dependent on weather patterns for rice production. Moreover, although the GOI has loosened restrictions on rice imports, some limitations remain. The price of cooking oil also has increased in recent years due to soaring global demand for palm oil. While the government has tried to manage price increases through export taxes, these policies have been largely ineffective to date, further straining the limited resources of poor families.

Poverty Persistence May Prompt Policy Shift

¶18. (SBU) Indonesia's macroeconomic outlook remains positive, with more stable prices, a stable currency, GDP growth expected to range between 6-7% for the next 12 months, improved investment rates, and modest job growth. These positive trends are the result of prudent monetary and fiscal policies of Bank Indonesia and the GOI's strong economic team. Yet, despite five quarters of GDP growth at or in excess of 6.0%, the number of people living at or near the poverty line remains high and standards of living among the majority of Indonesians have been slow to improve. The pressure of higher inflation remains due to high oil prices. If the current government's economic policy mix cannot generate jobs, reduce poverty and improve the standard of living for average Indonesians, pressure for policy changes with a more immediate impact are likely to mount. While significant policy changes in the near term are unlikely, some analysts have raised concerns that the government will direct lending or relax supervisory standards in order to spur credit expansion in labor-intensive industries, potentially undermining the health of the country's banks.

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